In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1334

W & W FERTILIZER CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question in this federal income tax case is whether the Court of Claims correctly held that petitioner's election to be taxed as a "small business corporation" under Sections 1371-1379 (Subchapter S) of the Internal Revenue Code of 1954 (26 U.S.C.) terminated when one of its shareholders transferred his stock to an inter vivos trust. Section 1371(a)(2) requires that each shareholder of such a "small business corporation" be either an estate or an individual.

The pertinent facts are as follows: In 1965, petitioner elected to be treated for federal income tax purposes as a "small business corporation" pursuant to Section 1371 *et seq.*, of the Internal Revenue Code of 1954. On February 25, 1970, one of petitioner's two shareholders, Lemuel P. Woods, established the Lemuel P. Woods Revocable Trust and transferred the shares of stock he owned in petitioner to the trust. Under the trust, the income was

to be paid to Woods for life and upon his death, the corpus was to be divided among his wife and family. Woods retained the power to revoke or amend the trust upon 90 days' notice (Pet. App. A-2).

In accordance with its broad powers, the trustee actively managed the corpus. For example, it took title to Lemuel Woods' real property and securities, paid his taxes, made investments, conveyed title to securities and real property, and provided financing for at least one of his businesses (Pet. App. A-8).

Petitioner filed an amended return and paid taxes for its fiscal year 1970 on the basis that its Subchapter S election had terminated because one of its shareholders was a trust. However, petitioner thereafter filed a claim for refund, asserting that it was still entitled to the benefits accorded to Subchapter S corporations. In this refund suit, the Court of Claims entered summary judgment for the government, holding that petitioner's Subchapter S election had terminated upon the transfer of shares to the Woods Trust (Pet. App. A-12).

The court below properly applied Sections 1371(a)(2) and 1372(e)(3) of the Code in holding that when the Woods Trust became a shareholder in petitioner, its Subchapter S election terminated. Section 1372(e)(3) provides that a Subchapter S election terminates for any taxable year in which the corporation ceases to meet the definitional requirements of a "small business corporation." One of these requirements is that the corporation must not "have as a shareholder a person (other than an estate) who is not an individual * * *." See Section 1371(a)(2) (Pet. App. B-1). In describing the manner in which these two interrelated provisions were to operate, the Senate Finance Committee stated (S. Rep. No. 1983, 85th Cong., 2d Sess. 217-218 (1958)):

> Under section 1372(e)(3), an election terminates if the corporation ceases to be a small-business corporation. Thus, if an eleventh person or a non-resident alien becomes a shareholder in the corporation, if a corporation, partnership, or *trust* becomes a shareholder, or if another class of stock is issued by the corporation, the election is thereby terminated. [Emphasis added.]

See Treasury Regulations on Income Tax (1954 Code), Sections 1.1371-1(e) and 1.1372-4(b)(3), 26 C.F.R. (Pet. App. B-2 to B-3). Thus, the decision of the Court of Claims is in accord with the language of the statute, the mandate of the Regulations and Congress' understanding of the statutory scheme. *Fulk & Needham, Inc.* v. *United States,* 411 F.2d 1403, 1406 (C.A. 4); *Old Virginia Brick Co.* v. *Commissioner,* 367 F.2d 276 (C.A. 4).[1]

Contrary to petitioner's argument (Pet. 7-8), the Woods Trust cannot be disregarded for tax purposes. The undisputed evidence showed that the trust was a bona fide entity. The trustee was actively involved in the business of managing the trust corpus and the trust was intended to have significant testamentary consequences under Florida law when the grantor died. Thus, the trust was distinguishable from the voting trusts in *A & N Furniture &*

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[1]Congress has rejected at least nine proposed amendments to Subchapter S which would have permitted trusts to be shareholders of such small business corporations. See, *e.g.*, H.R. 7237, 87th Cong., 1st. Sess. (1961); H.R. 7662, 87th Cong., 1st Sess. (1961); H.R. 9945, 87th Cong., 2d Sess. (1962); H.R. 340, 88th Cong., 1st Sess. (1963); H.R. 842, 88th Cong., 1st Sess. (1963); H.R. 2111, 88th Cong., 1st Sess. (1963); H.R. 473, 89th Cong., 1st Sess. (1965); H.R. 879, 89th Cong., 1st Sess. (1965); H.R. 13174, 92d Cong., 2d Sess. (1972). The last of these rejected bills would have specifically allowed trusts, such as the one involved in this case, to be Subchapter S shareholders.

Appliance Co. v. *United States*, 271 F. Supp. 40 (S.D. Ohio), and *LaFayette Distributors, Inc.* v. *United States*, 397 F. Supp. 719 (W.D. La.), upon which petitioner relies (Pet. 10-11).[2] In contrast to the voting trusts in those cases, the trust here was in economic and practical fact the owner of all substantial rights in the shares conveyed to it. Under those circumstances, there was no basis for concluding that the trust was anything other than a "shareholder" of petitioner.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

MAY 1976.

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[2]The trust was also distinguishable from the nominees, agents and custodians whose interests in stock have been held too ephemeral to warrant classifying them as "shareholders" for purposes of Section 1371. The requirement in Rev. Rul. 70-615, 1970-2 Cum. Bull. 169 (Pet. 11-12) that only owners of "beneficial" interests in stock be considered "stockholders" for purposes of the Subchapter S election was only addressed to a situation involving such nominal ownership interests.